CHAPTER 13
LAOS

Introduction. A quarter century after independence, Laos is the second poorest country (after Cambodia) in East Asia with a GNP per capita of about $330.

- Laos remains one of the few remaining communist economies in the world and one of the poorest nations on Earth.
- For most of the 5M people, simple subsistence is the norm.
- The average income is less than $1 a day.

Structural Woes. Laos faces a number of structural economic difficulties.

- Laos is a landlocked country with a primitive infrastructure.
- Laos has no railroads, a rudimentary road system, and limited external and internal telecommunications.
- Electricity is available in a few urban areas.
- Laos has a small industrial base and depends heavily on subsistence agriculture, which accounts for half of GDP and 80% of total employment.

Low De Facto GDP. To make a dent in widespread poverty, Laos must boost GDP close to 8% a year.

- Even the inflated official GDP figures of 6%, or more, fall short of the mark.
- More reliable private economists put the figure at closer to 2%-3%.
- Most of this growth comes from aid-induced growth in the construction sector.

Foreign Economic Relations

No Confidence. Economic indicators reflect low confidence in the Laotian economy.

- ***Foreign Direct Investment (FDI) Plummets.*** Most foreign investors (especially the Thai) have pulled out of Laos. Direct foreign investment approvals have declined from a peak of $2.6B in 1995 to just $20M last year.
- ***Weak Trade.*** Imports, mainly of consumer goods from Thailand, stood at $540M in 2000, while exports were only $323M.

Figure 13-A. Selected Historical Data

$ Billions (or %)	'97	'98	'99	'00
Gross National Income	1.9	..	1.4	1.7
Purchasing Power	6.0	6.6	8.8	8.3
Real Growth (%)	6.5	4	5	5.7
Inflation (%)	19.3	87.4	134	27.1
Exports	0.3	0.3	0.3	0.3
To U.S.	0.015	0.022	0.014	0.010
Imports	0.6	0.6	0.6	0.4
From U.S.	0.003	0.004	0.001	0.004
FDI from U.S.	-0.004	-0.006	-0.007	-0.009
In U.S.				
Cur Account /GDP %	-16.1	-10	-11.2	-5.8
Fiscal Balance /GDP %	1.7	2.4	-7.7	-6.2
External Debt /GDP %	136.1	199.1	181.4	

Sources: IMF, ADB, World Bank, U.S. Commerce

- ***Currency Collapse.*** The Lao currency, the kip, has plummeted to nearly 10,000 to the U.S. dollar from 7,900 in 2000, 4,250 in 1998 and 935 in 1996. Of the Southeast Asian currencies, only the Burmese kyat lost more in value over the same period.

Hooked on Foreign Aid. The government has become totally dependent on foreign aid.

- Foreign aid finances public- nvestment.
- Foreign aid also covers the severe current-account deficit in its balance of payments.
- In 1985-86, before the first tentative market reforms were introduced, foreign assistance accounted for 6.25% of Laos' meager GDP.
- By 1988, it had increased to 10%.
- Now it is more than 16%—a level at which self-sufficiency will be difficult to achieve.

Failure of Foreign Aid. This trend toward increasing dependence on foreign assistance is not unique to Laos. In fact, Laos fits a disturbing pattern of failing economic development programs worldwide.

- Poverty reduction—in the form of several decades of huge disbursements of development aid—simply hasn't worked, according to Vientiane-based German economist, Hans Luther.
- The number of countries with a per-capita income of less than $900 a year has risen to 49 today from 25 in 1971, and none have managed to rise out of the category in the past decade.

New IMF Plan. In April 2001, the International Monetary Fund approved in principle a threeyear arrangement for 31.7M Special Drawing Rights ($40.7M) to lift Laos out of poverty.

- Part of the plan is to restructure Laos' deeply insolvent state banks, to increase revenue collection to fund development projects, and to promote the private sector.

Early Optimism. Things were not always this bleak. In fact, back in the early 1990s, there was reason for cautious optimism.

- Laos is building up a textile industry.
- There was also hope for an expansion in energy exports from a string of planned hydroelectric plants.

Promising IMF Plan. In addition, Laos embarked upon promising IMF-sponsored economic reforms in 1989.

- These included an overhaul of the tax system, a two tier-banking system, lower tariffs, and privatization.
- Under the economic reforms of the New Economic Mechanism (NEM) in 1992, Laos made good progress towards a market economy.
- The economic reforms supported macroeconomic stability, and increased trade and investment flows.

Economic Progress. Thanks to the NEM's economic reforms, Laos demonstrated economic progress, at least for awhile.

- Laotian GDP growth averaged 7% for eight years.
- Inflation was also kept low.
- Since then, the Laotian economy has become mired in a dismal economic situation from which there seems to be no escape.

Reform Slows. Why the economic reversal? The momentum of economic reform in Laos had been flagging since 1997.

- Serious economic mismanagement, corruption, excessive government spending, and a huge trade deficit have recently plagued the economy.
- In particular, weak macroeconomic management was compounded by indecisive economic decision-making.
- This made it more difficult to react to the deteriorating macroeconomic situation.
- An inadequate regulatory framework, weak financial management, and high non-performing loans undermined banking.

Asian Economic Crisis

When several Asian economies crashed in 1997, many observers thought that Laos—with its small, mainly agricultural economy—would be shielded from the worst effects of the crisis. Wrong.

- Because Laos depends heavily on its economic relationship with Thailand, it was damaged when the Asian financial crisis that hit Thailand in July of 1997.
- Thailand, the biggest investor in Laos, was the first to pull out of Laos when the crisis hit their own country.

Vulnerability. The economic vulnerability of Laos to external shocks began to mount prior to the Asian economic crisis.

- The over-reliance of Laos on the Asian region for export markets, large savings, and trade receipts made it vulnerable to an Asian downturn in the region.

Impact of Asian Crisis. In the wake of the Asian economic crisis:

- FDI commitments to Laos fell by 91% and actual FDI flows declined by 41%.
- The Lao kip—closely linked to the Thai baht—was particularly vulnerable to exchange rate volatility that rocked the region. As a result, the kip lost 70% of its value vis-à-vis the US dollar between July 1997 and June 1998.
- Inflation also began to rise—and the social impact was significant. Inflation weakened economic confidence, which triggered an outflow of funds from the banking system.

Mitigating Factors. A number of factors mitigated the impact on the Laotian economy.

- Laos was insulated from the sharp credit crunches and rapid flight of portfolio investment (e.g. stocks and bonds).
- They were not integrated into the global financial markets and had received virtually no volatile, short-term capital inflows.

Growth Slows in 1998. These mitigating factors as well as favorable weather conditions (that led to a strong agricultural performance) helped Laos initially maintain robust growth of nearly 7% in 1997. But 1998 was a different story. Growth slowed to 4% in 1998.

Macroeconomic Mistakes. This economic slowdown reflects a number of serious macroeconomic mistakes Vientiane made in response to the Asian economic crisis.

- Vientiane unwisely pursued loose monetary and fiscal policies that multiplied the negative effects of the crisis on domestic macroeconomic stability.
- Vientiane's focus on food self-sufficiency led to extra-budgetary expenditures through rapid monetary expansion.
- Revenues fell short, resulting in a fiscal deficit in 1996/97 whose share of GDP was 1.5% higher than expected.
- Negative real interest rates, high inflation, and expectations of devaluation eroded investor confidence and accelerated the flight out of the kip.

Solutions

The Challenge. Regaining economic and financial stability is an immediate priority.

- Decisive action is needed to tighten monetary and fiscal policy.
- That will help stabilize the exchange rate and dampen inflationary pressures.
- A broad financial sector restructuring program is needed to improve the banks' ability to intermediate resources effectively.
- Laos will need to improve the climate for investment in order to restore external investment flows and boost exports.
- The depth and speed of the reform efforts of Laos cannot be underscored enough.
- Strong institutional capacity, good governance, and sound economic management will be critical for Laos.

Two Saving Graces. After 6.5% growth in 1997, the economy maintained a growth rate of 4% or more from 1998 through 2000.

- If the economy has so many problems, what's keeping the economy afloat?

1. "Gifts from Heaven." For now, many Lao rely on remittances from overseas.

- In 1975, some 350,000 Lao, almost 10% of the population at the time, left the country after the communists took power.
- In a recent survey, 56.5% of the population in Vientiane said they had relatives overseas and 48.1% of respondents said they received money from them.
- A State Planning Committee report lists "remittances from abroad" as the single most important source of income in the Vientiane valley, representing 28% of household earnings, in contrast to 25% from agriculture, 22% from wages, and 18% from business.

Unfortunately, these remittances are more likely to strengthen Laos' new role as an economic basket case than to lead to the kind of sustainable development that Laos needs to fight poverty effectively.

2. Donor Aid. For the foreseeable future, the economy will depend on aid from the IMF and other International Funding Institutions (IFIs).

- Foreign aid, mainly from Japan, Australia, and Sweden, covers trade and fiscal deficits.
- Aid provides 80% of the capital budget.
- But this international funding stopgap won't last forever.
- International donors from Japan, Sweden, and Australia are increasing the pressure for progress on reforms before making new disbursements, which already account for more than 16% of the country's GDP.

Economics/Security Link. Given this negative socioeconomic environment, it's not surprisingly that "the natives are restless."

- Popular pressure for economic and political change is growing and a protracted rebellion has erupted in the north.

The Political Economy. How is the government battling economic stagnation and the revived threat of Hmong insurgency?

- It attempted to attract foreign tourists—and the foreign currency they bring—by declaring 2000 "Visit Laos Year," that looked promising at the start. But a spate of bombings at bus stations, restaurants, and hotels killed the campaign.
- In essence, the Communist leadership "wants its cake and eat it too."
- The Laotian government remains dependent on Western foreign aid for its macroeconomic survival. It looks for creative ways fend off sanctions and cajole the West into still more economic carrots.
- Unfortunately, it shows no sign of pursuing serious market-oriented economic reform, despite signs that this impoverished nation could be entering the early phases of economic and political instability.
- In fact, Vientiane's Communist rulers—fearful of a threat to their rule—are turning back to their old fraternal communist parties in Vietnam and China.

Chinese Objectives. Closer relations track with China's larger diplomatic game of:

- Counterbalancing the U.S. and Japanese influence in the region and
- Providing China with a useful gateway for exporting cheap goods from Yunnan province into Southeast Asia.
- And unlike the Western pressure on Vientiane to become more market oriented and democratic, Beijing supports the status quo in Laos because Beijing is also trying to fend off pressure on itself to open up.

Chinese Carrots. Toward these ends, Beijing is using the opposite strategy from the West. It's using economic carrots (instead of sticks) to grease the skids with its Communist partner:

- Beijing has recently boosted both economic and military assistance to Vientiane.
- In celebration of the 25th anniversary of the Communist takeover in Laos, Beijing donated $7.2M to help build a mammoth Laotian cultural center.
- Vientiane also reportedly accepted interest-free foreign currency loans from Beijing to stabilize the embattled Laotian currency.

Conclusion

USG Policy. USG policy is awkwardly stuck in a "halfway house."

- Longstanding Western aid continues to prop up a communist leadership that opposes market reform anytime soon.
- Yet the World Bank (and others) has tied future economic assistance to economic and political reforms, which so far are going nowhere, or in a cosmetic direction at best.
- Similarly, economic and political relations have soured with USG, which continues to withhold normal trade relations.
- Meanwhile, Laotian Prince Soulivong—who is in exile in France—is leading a growing international chorus to "negotiate a transition" to a market-oriented democracy.

Strategic Questions to Ponder. Given the fact that we have seen little or no effort in Vientiane to pursue market reforms or open up politically, maybe we need to rethink U.S. policy toward Laos:

- Is international (Western) pressure on Laos proving counter-productive to achieving further economic reforms?
- Under such duress, will Laos come to rely more on China and Vietnam?
- In short, how can we best shape economic and political change in Laos?

Recommendation. The USG should develop creative new ways to promote a market-oriented democracy in Laos.

Final Thoughts. Laos remains one of the poorest nations in the world. After eight years of reforms and economic progress, reforms slowed in 1996. Internal economic mismanagement and the Asian economic crisis caused the economy to deteriorate. The currency collapsed, FDI fell, and inflation soared. Only remittances and donor support keep this economy afloat.

While China uses economic carrots to support the status quo in Vientiane, Western economic sticks are proving ineffective. Vientiane shows no sign of pursuing serious economic or political change. Perhaps it's time for us to take a new swing at Western policy.